99TH CONGRESS
1st Session
HOUSE OF REPRESENTATIVES
REPT. 99-188
Part 4

COMPACT OF FREE ASSOCIATION

JULY 20, 1985.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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Mr. ROSTENKOWSKI, from the Committee on Ways and Means, submitted the following

REPORT

together with

ADDITIONAL VIEWS

[To accompany H.J. Res. 187]

[Including Cost Estimate of the Congressional Budget Office]

The Committee on Ways and Means, to whom was referred the joint resolution (H.J. 187) to approve the "Compact of Free Association", and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the joint resolution as amended do pass.

The amendment is as follows:

At the end of the joint resolution, as reported, insert the following new title:

TITLE IV—CLARIFICATION OF CERTAIN TRADE AND TAX PROVISIONS OF THE COMPACT

SEC. 401. TRADE PROVISIONS.

Approval of the Compact may not be construed as effecting any change in the tariff treatment, under United States law, of articles that are the product of the Federated States of Micronesia or the Marshall Islands.

SEC. 402. CONSTRUCTION OF SECTION 253 OF THE COMPACT.

(a) EXEMPTION FROM UNITED STATES INCOME TAX NOT TO APPLY.—Subsection (a) of section 253 of the Compact shall not apply.

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(b) EXEMPTION FROM ESTATE AND GIFT TAXES, ETC., TO APPLY ONLY TO CERTAIN NONRESIDENTS.—Subsection (b) of section 253 of the Compact shall apply only to individuals who are nonresidents and not citizens of the United States.

SEC. 403. CONSTRUCTION OF SECTION 254 OF THE COMPACT.

The relief from liability referred to in the second sentence of section 254(a) of the Compact means only relief in the form of the foreign tax credit (or deduction in lieu thereof) available with respect to the income taxes of a possession of the United States.

SEC. 404. CONSTRUCTION OF SECTION 255 OF THE COMPACT.

Section 255 of the Compact shall be construed and applied as if it read as follows:

"Section 255

"(a) EXTENSION OF INCENTIVES.—The following provisions of the Internal Revenue Code of 1954 (as amended from time-to-time) shall apply to the Marshall Islands and the Federated States of Micronesia as if they were possessions of the United States: sections 48(a)(2)(B)(vii), 103, 103A, 170, 936, and 957(c).

"(b) EXCHANGE OF INFORMATION.—Subsection (a) shall not apply to the Marshall Islands and the Federated States of Micronesia (as the case may be) for any period after December 31, 1986, during which there is not in effect between the appropriate government and the United States an exchange of information agreement of the kind described in section 274(h)(6)(C) (other than clause (ii) thereof) of the Internal Revenue Code of 1954.

"(c) AUTHORIZATION OF APPROPRIATIONS.—There is hereby authorized to be appropriated to the Secretary of the Interior for transfer to the Governments of the Marshall Islands and the Federated States of Micronesia for each fiscal year beginning after October 1, 1985, such sums as may be necessary to compensate them during the period the Compact is in effect for the direct results of any reduction in tax incentives (as compared with such tax incentives in effect on October 1, 1985) by reason of the alteration of any provision of the Internal Revenue Code of 1954 set forth in subsection (a)."

SEC. 405. COMPACT DEFINED.

For purposes of this title, the term "Compact" means any Compact of Free Association set forth in this joint resolution and the subsidiary agreements thereto.

SEC. 406. COORDINATION WITH OTHER PROVISIONS.

Nothing in any provision of this joint resolution (other than this title) which is inconsistent with any provision of this title shall have any force or effect.

SEC. 407. EFFECTIVE DATE.

This title shall apply to income earned, and transactions occurring, after September 30, 1985, in taxable years ending after such date.

SEC. 408. STUDY OF TAX PROVISIONS.

The Secretary of the Treasury or his delegate—

(1) shall conduct a study of the effects of the tax provisions of the Compact (as clarified by the foregoing provisions of this title), and

(2) shall report the results of such study before October 1, 1987, to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate.

I. LEGISLATIVE BACKGROUND

The executive branch request to approve the Compact of Free Association (the "Compact") Between the United States and the Governments of the Marshall Islands and the Federated States of Micronesia was transmitted to the 98th Congress on March 30, 1984. The draft joint resolution was introduced by request on June 29, 1984, by Mr. Fascell, Mr. Broomfield, Mr. Solarz, and Mr. Prichard, as House Joint Resolution 620. The legislation was jointly referred to the Committee on Interior and Insular Affairs and to the Committee on Foreign Affairs. The Interior Committee held extensive hearings on the legislation during the 98th Congress, and the Foreign Affairs Committee held a full committee hearing on House Joint Resolution 620 on September 18, 1984. The resolution expired without further action at the end of the 98th Congress.

On February 20, 1985, the executive branch resubmitted draft legislation to approve the Compact (H. Doc. 99-29), which was subsequently introduced by request on May 9, 1985, by Mr. Fascell, Mr. Udall, Mr. Seiberling, Mr. Solarz, and Mr. Lagomarsino, as House Joint Resolution 187. The legislation was again jointly referred to the Committee on Interior and Insular Affairs, which held further hearings on the legislation, and to the Committee on Foreign Affairs.

The Committee on Foreign Affairs approved the Compact with amendments (H. Rep. 99-188, Part 1, July 1, 1985), as did the Committee on Interior and Insular Affairs (H. Rep. 99-188, Part 2, July 15, 1985).

On July 15, 1985, House Joint Resolution 187 was referred to the Committee on Ways and Means for consideration of the tax and trade aspects of the proposed Compact.

II. COMMITTEE ACTION

On July 18, 1985, the Committee on Ways and Means marked up the legislation and approved House Joint Resolution 187, with amendments, by voice vote.

III. PURPOSE

The purpose of House Joint Resolution 187, as amended, is to approve the Compact of Free Association Between the United States and the Governments of the Republic of the Marshall Islands and the Federated States of Micronesia. The Republic of the Marshall Islands and the Federated States of Micronesia, are two of the four governments comprising the Trust Territory of the Pacific Islands.

The compact sets the terms for the termination of the trusteeship and, if approved, would govern relationships between these two governments and the United States in the post-trusteeship period.

IV. EXPLANATION OF COMMITTEE AMENDMENTS

A. Overview of Compact

The Trust Territory of the Pacific Islands was created in 1947 by an international "trusteeship agreement" under the sponsorship of the United Nations. The United States has administered the Trust Territory since that time, pursuant to the authority granted by the agreement. Thus, the legal basis of U.S. authority in the Trust Territory has been quite different from the basis of its authority in its possessions, such as Puerto Rico, the Virgin Islands, or Guam. The U.S. exercises sovereignty over those possessions, while it has governed the Trust Territory under an international legal agreement, without any claim to sovereignty, and with the ultimate goal of making the Trust Territories self-determining states in their own right. To that end, U.S. control over two jurisdictions of the Trust Territory would be largely eliminated under the proposed Compact of Free Association with the Marshall Islands and with the Federated States of Micronesia (hereinafter, the "Freely Associated States").

The Compact would establish a relationship which is neither commonwealth status, under which the Freely Associated States would submit to U.S. sovereignty, nor fully independent status. Under the terms of the proposed Compact, the Freely Associated States would be self-determining sovereign states with full control over their internal and external affairs. However, the U.S. would retain authority over all matters concerning security and defense of the area, including the right to place military bases there. Under the Compact, the United States will pay nearly $3 billion to the Freely Associated States over the next 15 years, in the form of economic assistance and settlement of outstanding claims. In addition, numerous other forms of cooperation between the governments of the U.S. and the Freely Associated States will continue, including, for example, agreements relating to telecommunications, postal services, weather service, and mutual assistance in law enforcement matters. The terms of the Compact itself are amplified by a number of subsidiary agreements accompanying the Compact.

B. Tax Provisions

Present Law

Because the Trust Territory of the Pacific Islands has never been a true territory or possession of the United States, the Freely Associated States have never been treated as possessions for U.S. tax purposes. Rather, those States have been treated as foreign countries, subject to the normal U.S. international tax rules. In general, those rules provide that U.S. taxpayers are fully subject to U.S. tax on income earned anywhere in the world. However, any foreign taxes paid on income earned abroad may be credited against the U.S. tax payable on such income. Thus, when taxes have been im-

posed on U.S. taxpayers by the Freely Associated States, those taxes have been creditable against U.S. tax liability. An alternative benefit may be available to individual taxpayers under section 911 or 912 of the Internal Revenue Code; section 911 allows private sector workers to exclude from gross income for U.S. tax purposes up to $80,000 (for 1985) of income earned abroad (plus a housing cost allowance), while section 912 grants an exclusion for certain cost-of-living and other allowances paid to U.S. government employees outside of the 48 contiguous states. The Freely Associated States have imposed relatively low taxes on gross wages and salaries (six percent of the first $11,000 and 10 percent of amounts above that) and on the gross income of businesses (businesses that earn between $2,000 and $10,000 pay a flat $80 tax, and businesses earning more than $10,000 also pay a three percent tax on the excess).

With respect to foreign persons earning income from sources within the United States, the United States applies different taxing rules to different types of income. Income from U.S. sources that is effectively connected with a U.S. trade or business is taxed under normal U.S. income tax rules (i.e., on a net basis at graduated rates). On the other hand, U.S.-source income that is not connected with the taxpayer's trade or business (typically dividends, rents, royalties, and some interest) is taxed at the flat rate of 30 percent of the gross amount of income. The 30-percent rate is often modified by treaty. (Because this tax is collected by requiring the U.S. payor to withhold the tax from amounts paid, it is often called the "withholding tax.")

With respect to foreign persons holding property in the United States, the United States imposes estate tax with respect to all U.S.-situs assets. (In the case of citizens and domiciliaries, estate tax is imposed with respect to the worldwide assets of the decedent.) However, under present law, a unified credit against estate and gift taxes in effect exempts a cumulative amount of transfers from these taxes. For decedents dying in 1985, the cumulative exemption is $400,000, $500,000 in 1986, and $600,000 in 1987 and later years. Generation-skipping transfer tax liability is determined under similar rules.

The Freely Associated States, residents of those States, and U.S. investors in those States have been fully subject to the above rules. None of the Internal Revenue Code's special rules applicable to possessions has previously been applied to the Freely Associated States. Those special rules include the following:

(1) Section 48 makes an investment tax credit available for property used in a possession in some cases;

(2) Sections 103 and 103A exempt from U.S. tax income earned on qualified obligations of a possession;

(3) Section 168 allows accelerated depreciation to taxpayers who use property in a possession in some cases;

(4) Section 170 provides a deduction for contributions to a charitable organization in a possession;

(5) Section 936 provides a credit that offsets all U.S. tax on qualified income of U.S. corporations operating primarily in the possessions; and

(6) Section 957(c) excepts U.S. shareholders of certain corporations organized and operating in the possessions from the application of certain rules that would otherwise impose current tax on the shareholders when the corporation received passive and other tax-haven type income.

The Administration has proposed as part of its tax reform plan ("The President's Proposals to the Congress for Fairness, Growth, and Simplicity," May 1985, referred to as the Administration Proposal) the repeal or revision of all of these rules, including the repeal of the investment tax credit, the possession tax credit (section 936), and the special treatment of U.S. shareholders of possessions corporations that have tax-haven type income.

Administration Proposal

The terms of the Compact relating to taxation are set forth in sections 251 through 255. Section 251 establishes the U.S. dollar as the currency of the Freely Associated States.

Section 252 provides that the Freely Associated States may tax U.S. persons on income earned in, property located in, or products consumed in the Freely Associated States. The source of income and the location of property are to be determined under the U.S. Internal Revenue Code.

Section 253 exempts citizens of the Freely Associated States who are domiciled there from U.S. tax on noneffectively connected income and also exempts them from U.S. estate, gift, and generation-skipping transfer taxes. The terms "citizen" and "domicile" are not defined in the Compact for purposes of section 253.

Section 254 provides that the Freely Associated States may tax income that residents of those states receive from sources outside the States, provided that such tax is equivalent to the tax imposed on income from sources within those States. In addition, section 254 provides that a resident of the Freely Associated States is entirely exempt from U.S. tax on any income that is taxed by the Freely Associated States. The section specifies that for this purpose any person physically present in the Freely Associated States for 183 days during a taxable year will be considered a resident.

Finally, section 255 provides that the provisions of the Internal Revenue Code that applied to possessions as of January 1, 1980, will be applied to the Freely Associated States, unless manifestly inconsistent with the intent of the Compact. The major provisions that would apply are those set forth above in the discussion of present law. The section provides that if those rules are changed after January 1, 1980, they are to remain in effect for two years, during which time an agreement to provide "substantively equivalent" benefits must be negotiated between the United States and the Freely Associated States. It should be noted that those rules have been changed since January 1, 1980. First, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) amended section 936 to limit taxpayers' ability to allocate excessive amounts of income from intangible property to tax-exempt possessions corporations. Second, the Deficit Reduction Act of 1984 placed volume limitations upon tax-exempt possessions obligations issued for private activities (e.g., Industrial Development Bonds).

It should also be noted that the Administration has proposed substantial revisions to the tax treatment of the possessions, as part of its tax reform proposal. Most importantly, these revisions would eliminate the section 936 possessions tax credit, and replace it with a credit based on wages paid by manufacturing establishments in the possessions. In addition, these revisions would in general attempt to simplify the tax rules applicable to the possessions by more consistently treating them as foreign countries with tax systems distinct from that of the United States. Less reliance would be placed on the "mirror system," under which the United States and some possessions treat one another as foreign countries for tax purposes, but the possessions do so by applying the Internal Revenue Code, with appropriate adjustments. Other changes proposed by the Administration that would affect the possessions but would be overriden by section 255's freezing of current law include repeal of the investment tax credit, modification of the depreciation rules, repeal of the tax exemption for private activity state and local bonds (IDBs), and repeal of special treatment for tax haven type income of certain possessions corporations.

No provision is made in the Compact for the exchange of tax information or for other mutual assistance in tax matters.

Proposed Interior and Insular Affairs Committee Amendments

The House Committee on Interior and Insular Affairs has approved the Compact, with the following amendments relating to the taxation provisions of the Compact.

First, that portion of section 254 which exempts residents of the Freely Associated States from U.S. tax would be rendered ineffective.

Second, section 255 would be amended to make the Freely Associated States subject to the provisions that applied to possessions as of January 1, 1985, rather than January 1, 1980. Again, any changes to the possessions rules would require the negotiation of equivalent benefits within two years. In addition, Congress would specify that no possession of the United States will be treated less advantageously than the Freely Associated States.

The House Committee on Foreign Affairs has approved the Compact without any amendments relating to its tax provisions.

Reasons for Change

The provisions of the Compact as proposed by the Administration are intended to strengthen the economy of the Freely Associated States by encouraging U.S. taxpayers to settle and invest in those States. The Compact would do so, first, through the provision of a U.S. tax exemption for persons otherwise subject to U.S. tax who reside in the Freely Associated States for at least six months a year. Second, it would do so by making available to U.S. investors in the Freely Associated States the same incentives that are available for investing in the U.S. possessions, including most notably the exemption from tax provided under section 936 for certain income earned in the possessions. The availability of these or "substantively similar" incentives would be guaranteed for a period of 15 years, giving U.S. investors certainty as to the tax treatment of

investments in the Freely Associated States, which would further encourage investment. However, the Committee believes that some of the Compact's provisions are either inconsistent with their stated purpose, potentially subject to abuse, or inconsistent with general U.S. tax policy.

The Committee believes that the exemptions provided by proposed section 253, from U.S. tax on noneffectively connected income and from U.S. transfer taxes, could easily be abused. The exemptions would be available to any citizen of the Freely Associated States who is domiciled there. The Freely Associated States could thus make the exemptions widely available by enacting laws making it relatively easily to acquire citizenship and domicile in those States. Thus, U.S. taxpayers, and foreign taxpayers with investments in the United States, could avoid U.S. tax on passive income (e.g., dividends) simply by acquiring citizenship and domicile in the Freely Associated States. Similarly, U.S. taxpayers would be able to avoid U.S. estate tax by acquiring citizenship and domicile. The Committee is less concerned with potential usage of the device by foreign persons as a means of avoiding U.S. estate tax, since foreign persons in the aggregate pay little U.S. estate tax. The Committee also notes that the effect of section 253 appears to be inconsistent with the goal of strengthening the economy of the Freely Associated States by increasing the levels of investment in those States, since it provides citizens of the States with an incentive to invest in the United States. The Committee understands that this provision was included in the Compact for the limited purpose of insuring that citizens of the Freely Associated States who work in the United States for a period of years (but are still domiciled in the Freely Associated States) are not subjected to U.S. estate tax.

In the Committee's view, section 254 presents even greater potential for abuse, since it provides any six-month resident of the Freely Associated States with a complete exemption from U.S. tax on any income that is also taxed by the Freely Associated States. The Freely Associated States have historically imposed taxes at a very low level. Thus, any U.S. individual or any foreign individual with substantial amounts of U.S. income could avoid U.S. tax simply by spending six months of each year in the Freely Associated States and paying relatively low taxes there with respect to that income. The United States could lose substantial tax revenue from individuals with unearned income, and others whose jobs give them flexibility as to the place and time that they work. Some taxpayers might seek to bunch income into years when they qualified for the exemption. Further, the Freely Associated States would have little incentive to inquire very closely as to whether such individuals in fact spent the required six months in those States, since any individual making such a claim would be doing so by filing a tax return and making payment. Thus, the revenue loss could be exacerbated by false claims of residence in the Freely Associated States. While the amendment concerning section 254 proposed by the House Committee on Interior and Insular Affairs would address these concerns by preserving normal U.S. taxing rules, the Committee finds it appropriate to make its own amendment addressing this section.

The Committee believes that if it is necessary to encourage investment in the Freely Associated States, the basic approach of section 255 is a useful one, but that amendments are necessary to reflect tax policy considerations and to ensure equitable treatment of the possessions of the United States. Section 255 as proposed would grant to investments in the Freely Associated States the benefits that applied to U.S. possessions as of January 1, 1980. Turning the clock back in this manner would render inapplicable to the Freely Associated States several significant changes in the Code that have been made since that date that now apply to the possessions. Most notably, the 1982 TEFRA amendments to section 936 that were intended to limit abuses with respect to income from intangible property would not apply to the Freely Associated States, nor would the Industrial Development Bond (IDB) volume cap enacted by the Deficit Reduction Act of 1984.

The amendment to section 255 proposed by the House Committee on Interior and Insular Affairs would address this concern by adopting the possessions rules as of January 1, 1985. However, the Interior Committee amendment would also freeze those rules in place for two years after Congress enacted any amendment of those rules, and require negotiations to provide "substantially equivalent" benefits thereafter. (The Compact as proposed would similarly have frozen the 1980 rules for two years after any amendments, and required negotiations to provide "*substantively* equivalent" benefits.) In addition, under the amendment proposed by the Interior Committee, the substantially equivalent benefits negotiated with the Freely Associated States must be equaled for the possessions. Thus, section 255 as amended would have the effect of freezing the rules of present law, with respect to both the Freely Associated States and the possessions, since any change in the law would have to be met with new benefits for both that were equivalent in substance to the old law.

The Committee does not believe it appropriate to apply to the Freely Associated States a rule that is based on the treatment of the possessions but gives to those States a greater benefit than is available to the possessions, especially when Congress recently reduced the incentives for the possessions because of potential tax abuses. The Committee also feels that applying pre-TEFRA law to the Freely Associated States, or providing for a two-year extension of existing law to benefit the Freely Associated States, would constitute such a benefit. Nor does the Committee believe it appropriate to freeze into place existing (or prior) rules applicable to the possessions at the very moment that Congress is considering proposals advanced by the Administration and others to amend those rules substantially.

Nevertheless, the Committee fully recognizes the strategic importance of the Compact, and the importance of providing incentives for investment in the Freely Associated States in a manner that adheres to the spirit and intent of a mutually negotiated agreement. Moreover, the Committee recognizes the special relationship between the United States and the Freely Associated States, that arises out of the trusteeship. Therefore, the Committee supports the extension to the Freely Associated States of investment incentives applicable to the possessions, much as contemplated by the

Compact as initially proposed. The Committee insists, however, that such incentives not be made available to the Freely Associated States at any time when they are unavailable with respect to the possessions. In addition, the Committee emphasizes that the application of the present possessions rules to the Freely Associated States does not represent an endorsement of those rules as they presently stand. The use of those rules is accepted as a part of a mutually negotiated agreement that is of substantial importance to the United States, and does not represent a precedent of any kind with respect to the Committee's judgment as to the merits of those rules. If and when Congress and the Committee decide to change tax rules applicable to the possessions, they will make their decisions on the basis of what is best for the possessions in particular and for the United States in general, and not as part of a negotiated bargain.

The Committee believes that Congress' flexibility to make appropriate changes in the law should not be impeded, particularly at a time when the entire tax code is being examined, and may be substantially amended. Therefore, the Committee is unwilling to extend possessions benefits to the Freely Associated States in a manner that would freeze the substance of those benefits in place. On the other hand, the Committee recognizes the unique character of the Compact as a negotiated agreement that involves U.S. concessions on tax matters as a quid pro quo for benefits granted by the Freely Associated States. Therefore, to assure the Freely Associated States that any modification of the above incentives will not operate to their detriment, the Committee is willing to authorize direct appropriations to the Freely Associated States to replace any benefit that is lost as a result of such changes. The Committee expects that, in making appropriations pursuant to this provision, the Appropriations Committee will consider the tax expenditures eliminated by any change. The Committee believes that such a provision for monetary reimbursement is more appropriate than a rule that would limit Congress' ability to make necessary changes to the tax law. Further, the Committee again emphasizes that this provision is adopted in a unique contractual context and does not represent a precedent applicable to other cases. The Committee emphasizes the unprecedented nature of the agreement entered into by the Freely Associated States, in which those States have ceded to the United States a significant measure of their sovereignty.

The Committee also concludes that if possessions benefits are to be extended to the Freely Associated States, then consistency requires that the benefits of code section 911 not be available to U.S. persons working in those States. Section 911, which permits a U.S. taxpayer to exclude from gross income up to $80,000 of foreign earned income for U.S. tax purposes (in 1985), does not apply to the possessions. On the other hand, the Committee does not believe it appropriate to apply to the Freely Associated States an exemption comparable to those applicable to the possessions (e.g., sections 931, 933, and 934). Those exemptions are provided on the assumption that U.S. persons will be subject to a level of taxation in the possessions approximately equal to the level of taxation that would otherwise apply in the United States. Indeed, the possessions do in fact impose tax that equal or exceed those that the United States would

impose on these persons. In the case of the Freely Associated States, however, no such comparable tax will apply. Therefore, the Committee sees no reason to grant a comparable exemption. The Committee does feel that any income taxes imposed by the Freely Associated States should be creditable or deductible under normal U.S. rules.

The Committee is also concerned that the extension of possessions treatment to legally independent countries will present compliance and coordination difficulties that do not exist in the case of the possessions. For example, no provision is made for exchange of information between the tax authorities of the United States and the Freely Associated States. Such exchange of information is necessary to ensure each country's ability to verify that the Compact is not subject to abuse. Therefore, the Committee believes that exchange of information agreements should be entered into between the United States and the Associated States, to facilitate cooperation between the relevant taxing authorities comparable to that between the taxing authorities of the United States and the possessions. To allow time for the negotiation of such an agreement, the Committee would require it only by January 1, 1987.

Because of its concerns with respect to the administration of the taxation provisions of the Compact, the Committee believes that Treasury should be required to study the operation of those provisions and report to the Congress the results of that study. Such a study may reveal unanticipated problems with the respect to the application of these provisions.

Explanation of Provisions

The Committee amendment is intended to eliminate the potential for abuse of the Compact by U.S. and foreign taxpayers and to provide equity and flexibility with respect to U.S. tax treatment of the possessions, while allowing substantial benefits as contemplated by the Compact. The Committee amendment in several respects treats the Freely Associated States in a manner consistent with the treatment of possessions for U.S. tax purposes. The Committee amendment modifies the application of sections 253–255 of the Compact.

Section 253—Exemption from U.S. tax

That portion of section 253 of the Compact which provides an exemption from the U.S. tax on passive income is overridden with respect to any recipient of such income. Therefore, normal U.S. taxing rules will apply with respect to any payment of such income from a U.S. source to a citizen of the Freely Associated States. On the other hand, that portion of section 253 which provides an exemption from U.S. estate, gift, and generation skipping transfer taxes is overridden only with respect to U.S. citizens and residents. Thus, the amendment limits abuse while preserving much of the section's intended effect (protection from U.S. estate tax for citizens of the Freely Associated States who work in the United States but do not become U.S. residents). Although nonresident aliens with property in the United States could use this provision to avoid U.S. estate tax, this potential for abuse is relatively insignificant, since

such persons are unlikely to be subject to U.S. estate tax in any event.

Section 254—Overlap of U.S. and Freely Associated States tax

That portion of section 254 of the Compact which exempts any resident of the Freely Associated States from U.S. tax on income that is also taxed by the Freely Associated States is overridden. Thus, U.S. persons who are residents of the Freely Associated States will remain subject to U.S. tax on their worldwide income. Nonresident aliens who are residents of the Freely Associated States will remain subject to tax on their U.S. source income and their effectively connected income. In addition, the Committee intends that to maintain consistency with the treatment of the possessions, U.S. taxpayers working in the Freely Associated States will not be permitted to exclude their earnings from gross income pursuant to section 911.

Section 255—Business investment tax provisions

Section 255 of the Compact is amended to provide that the following business investment incentives applicable to the possessions will also apply, as they may be amended from time to time, to the Freely Associated States (subject to the conditions, limitations, and exclusions of each):

(1) Section 48(a)(2)(B)(vii), making an investment tax credit available for property used in the Freely Associated States in some cases (this will also make accelerated depreciation under section 168 available, by cross-reference);

(2) Sections 103 and 103A, exempting from U.S. tax income earned on qualified obligations of the Freely Associated States, subject, for example, to the $150 per capita volume cap on IDBs.

(3) Section 170, providing a deduction for contributions to charitable organizations in the Freely Associated States;

(4) Section 936, providing a credit that offsets all U.S. tax on qualified income of U.S. corporations operating primarily in the Freely Associated States; and

(5) Section 957(c), excepting U.S. shareholders of certain corporations organized and operating in the Freely Associated States from the application of certain rules that would otherwise impose current tax on the shareholders when the corporation received passive and other tax-haven type income.

In addition, the Committee's amendments provide that the above provisions will cease to apply to the Freely Associated States as of January 1, 1987, unless by that date the United States and the Freely Associated States have entered into an agreement to exchange tax information of the kind described in the Caribbean Basin Initiative legislation. If any of the applicable incentives are modified in the future, appropriations are authorized to reimburse the Freely Associated States to the extent of any benefits that are lost. The Committee's amendments also direct the Secretary of the Treasury to prepare a study by October 1, 1987, with respect to the operation of the tax provisions of the Compact.

These amendments make available to investment in the Freely Associated States the substantial incentives that presently apply to investment in the possessions, much as contemplated by the Com-

pact as initially proposed. The primary differences from the initial proposal and the Interior Committee amendments are that (1) the incentives are not frozen in place (as of either 1980 or 1985), (2) no two-year extension is provided in the event of any modification of those rules, and (3) the benefits beyond 1986 are made contingent on the conclusion of an agreement to exchange tax information. Thus, the Freely Associated States will not receive the benefit of these incentives at a time when they are unavailable with respect to the possessions. Further, Congress' flexibility to make appropriate changes in the law will not be impeded. The Committee believes that such a provision for monetary reimbursement is more appropriate than a rule that would limit Congress' ability to make necessary changes to the tax law. Further, the Committee again emphasizes that this provision is adopted in a unique contractual context and does not represent a precedent applicable to other cases.

Effective Date

The tax provisions of the Compact, as amended, are proposed to be effective with respect to income earned and transactions occurring on or after October 1, 1985, as contemplated by the proposed Compact.

Revenue Effect

The tax provisions of the Compact, as amended, are estimated to decrease fiscal year budget receipts by $3 million in 1986, $3 million in 1987, $3 million in 1988, $3 million in 1989, and $3 million in 1990.

C. Trade Provisions

Present Law

As in the tax area, the Freely Associated States have never been treated as possessions for U.S. tariff purposes. Rather, they have been treated as foreign countries, the products of which are subject to the duties prescribed in the Tariff Schedules of the United States (TSUS), 19 U.S.C. 1202, when imported into the United States.

The Trust Territory of the Pacific Islands has been designated by the President as a beneficiary developing country for purposes of receiving duty-free treatment on eligible articles under the Generalized System of Preferences (GSP) authorized under Title V of the Trade Act of 1974, as amended. In order to be eligible for such duty-free treatment, the imported articles (1) must be imported directly into the customs territory of the United States and (2) the sum of the cost or value of materials produced in the Trust Territory plus the direct costs of processing operations performed in the Territory must not be less than 35 percent of the appraised value of the imported article.

All imported articles are eligible for GSP treatment unless they are specifically excluded by statute (textiles and apparel; watches; import-sensitive electronic, steel and glass products; footwear and other leather products) or are determined by the President to be

import-sensitive. Duty-free GSP treatment applies unless imports from a particular beneficiary country of a particular eligible article exceed "competitive need" limits of 50 percent of total imports of the article or a dollar value tied to annual changes in U.S. GNP (currently about $64 million). These limits may be waived if imports are de minimis or the article is not produced in the United States.

Administration Proposal

Section 242 of the Compact of Free Association would extend tariff treatment to the Freely Associated States which is identical to that currently provided to U.S. insular possessions through the application of General Headnote 3(a) of the TSUS. Thus, imports from such States would be entitled to duty-free treatment if no more than 70 percent (or 50 percent for certain import sensitive articles) of the total value of the article is of foreign origin.

Proposed Amendment

The House Committee on Interior and Insular Affairs has approved the Compact with an amendment to section 242 providing that products of the Associated States are entitled to the same tariff treatment as that accorded to beneficiary countries under the Caribbean Basin Initiative (CBI) program and are subject to the same product exclusions. The products excluded by statute from CBI coverage are textiles and apparel, footwear and other leather products, watches and watch parts, canned tuna, and petroleum and petroleum products. The rule-of-origin requirements for CBI duty-free treatment are identical to the origin rules under the GSP program, except that up to 15 percent of U.S. materials may be counted toward the minimum 35 percent local content requirement.

Reasons for Change

Application of General Headnote 3(a) to imports from the Freely Associated States would result in more liberal tariff treatment than the States currently receive under the GSP program. In applying the 70 percent test, the U.S. Customs Service determines the value of foreign materials by their actual purchase price plus the cost of transportation to the possession, excluding any duties or taxes assessed by the possession and any post-landing charges. The GSP and CBI rules require a determination of the actual cost or value of materials produced and processing operations performed in the country; simply increasing the export price of the article does not meet the rule-of-origin tests under these programs.

The Committee is concerned that the more liberal General Headnote 3(a) treatment could result in circumvention of the tariff laws with minimal transformation of foreign materials, particularly from the Far East, in the Associated States prior to their shipment to the United States. The rule-of-origin requirements enacted since General Headnote 3(a) for the GSP and CBI programs and, most recently, in legislation implementing the U.S.-Israel Free Trade Area Agreement, require substantial transformation in the country of

origin and specifically preclude various forms of mere pass-through operations from meeting local content requirements. The Committee believes that these stricter requirements are also in the best interest of the Associated States by ensuring that meaningful operations are performed locally that will attract industry and encourage overall economic development.

The Committee also believes that extension of the CBI program or General Headnote 3(a) to the Associated States is not an appropriate policy. The CBI was designed specifically to give special preferential advantages to a region in close proximity to the United States with particular economic, political, and security interests in mind. The Committee sees no rationale for establishing a precedent of extending those advantages to the Pacific. It is highly unlikely that the Associated States would receive significantly greater economic advantages under the CBI program in view of their relatively low level of economic development. Treatment of the Associated States as insular possessions for purposes of General Headnote 3(a) would be inconsistent with their treatment under the Compact as sovereign states with respect to matters other than security and defense. On the other hand, retention of current GSP treatment with respect to the Associated States would be consistent with the objective sought by the Congress and the U.S. Customs Service of maximum uniformity in the application of rule-of-origin requirements under various trade programs.

Explanation of Provision

The provision reported by the Committee on Ways and Means would make clear that tariff treatment under present law, including beneficiary country status of the Freely Associated States under the GSP, would continue to apply to their products.

Effective Date

The trade provisions of the Compact, as amended, are proposed to be effective with respect to transactions occurring on or after October 1, 1985.

Revenue Effect

The trade provisions of the Compact, as amended, are estimated to have a negligible impact on budget receipts.

V. BUDGET EFFECTS

In compliance with clause 7 of Rule XIII of the Rules of the House of Representatives, the following statement is made concerning the effect on the budget of the tax and trade provisions of H.J. Res. 187, as reported by the Committee.

The tax provisions of H.J. Res. 187, as amended by the Committee, are estimated to reduce fiscal year budget receipts by $3 million per year for 1986–1990. The trade provisions are estimated to have a negligible impact on budget receipts.

The Treasury Department agrees with this statement.

VI. VOTE OF THE COMMITTEE AND OTHER MATTERS TO BE DISCUSSED UNDER HOUSE RULES

A. Vote of the Committee

In compliance with clause 2(l)(2)(B) of Rule XI of the Rules of the House of Representatives, the following statement is made concerning the vote of the Committee on the motion to report H.J. Res. 187, as amended. H.J. Res. 187, as amended, was ordered favorably reported by voice vote.

B. Other Matters

In compliance with clauses 2(l)(3) and 2(l)(4) of Rule XI of the Rules of the House of Representatives, the following statements are made with respect to the committee action on H.J. Res. 187, as amended.

Oversight Findings

With respect to subdivision (A) of clause 2(l)(3) (relating to oversight findings), the Committee advises that it was as a result of the Committee's review of the tax and trade aspects of the proposed Compact of Free Association (H.J. Res. 187) that the Committee concluded that it is appropriate to approve the resolution with an amendment.

Tax Expenditures

With respect to subdivision (B) of clause 2(l)(3), after consultation with the Director of the Congressional Budget Office, the Committee states that the tax changes made by H.J. Res. 187 as amended by the Committee involve an increase in tax expenditures of $3 million per year for fiscal years 1986–1990.

New Budget Authority

With respect to subdivision (B) of clause 2(l)(3), after consultation with the Director of Congressional Budget Office, the Committee states that the changes made by H.J. Res. 187 as amended by the Committee involve new budget authority of an undetermined amount, as there is authorized to be appropriated to the Secretary of the Interior for transfer to the Governments of the Marshall Islands and the Federated States of Micronesia for each fiscal year beginning after October 1, 1985, "such sums as may be necessary to compensate them during the period the Compact is in effect for any reduction in tax incentives (as compared with such tax incentives in effect on October 1, 1985) which is the direct result of the alteration of any provision in the Internal Revenue Code of 1954 set forth in [secs. 48(a)(2)(B)(vii), 103, 103A, 170, 936, and 957(c)]."

Congressional Budget Office Estimates

With respect to subdivision (C) of clause 2(l)(3), the Committee advises that the Director of the Congressional Budget Office has examined the Committee's budget estimates (as indicated in Part V of this report) and agrees with the budget estimates.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, July 22, 1985.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, U.S. House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has examined an amendment to H.J. Res. 187, a joint House resolution to approve the Compact of Free Association between the United States and the Marshall Islands and the Federated States of Micronesia and to approve conditionally the Compact of Free Association with Palau, as ordered reported by the Committee on Ways and Means on July 18, 1985.

The amendment clarifies the trade and tax provisions of the Compact which would become effective October 1, 1985. Section 301 of the amendment supercedes sections 241 thru 243 of the Compact. The amendment states that the freely associated states (FAS) shall continue to be included in the customs territory of the United States therefore resulting in no revenue loss of customs duties collections due to enactment of the Compact. Section 302 of the amendment would allow a resident citizen of the FAS who is a nonresident and non-citizen of the United States to be exempt from estate and gift and generation-skipping transfer taxes imposed by the government of the United States, while removing from the Compact a provision that exempts FAS citizens from United States income tax. Further, section 304 of the amendment would make various tax incentives available for investments made in the FAS, thereby treating them as if they were possessions of the United States, subject to termination for any period after December 31, 1986 in which no exchange of tax information occurs between the appropriate government and the United States. The amendment would also require that the Secretary of the Treasury or his delegate conduct a study of the tax provisions of the Compact and report the results of the study to the House Committee on Ways and Means and the Senate Committee on Finance before October 1, 1987.

The Congressional Budget Office has reviewed and concurs with estimates of the revenue effects of the amendment to H.J. Res. 187 prepared by the Joint Committee on Taxation. The joint resolution would reduce fiscal year revenues in each year from 1986 through 1990 by $3 million.

If you have any questions, please feel free to contact me, or your staff may wish to contact Neil Fisher of CBO's Tax Analysis Division.

With best wishes,
Sincerely,

ERIC HANUSHEK
(For Rudolph G. Penner, Director).

Oversight by Committee on Governmental Operations

With respect to subdivision (D) of clause 2(l)(3), the Committee advises that no oversight findings or recommendations have been

submitted by the Committee on Government Operations regarding the subject matter of H.J. Res. 187.

Inflationary Impact

In compliance with clause 2(l)(4), the Committee states that the enactment of the tax and trade provisions of H.J. Res. 187, as amended by the Committee, is not expected to have any inflationary impact on prices and costs in the operation of the national economy.

VII. ADDITIONAL VIEWS TO H.J. RES. 187 BY HON. BRIAN DONNELLY

I voted to report H.J. Res. 187 from the Ways and Means Committee, but I have serious reservations about the consideration procedure that was imposed on the Committee.

This Committee was required to adhere to a stringent timetable for considering the Compact of Free Association's trade and tax provisions. Those provisions would have a significant impact, directly at variance with the goals of tax reform, fairness and simplicity. There has been no time to hold hearings. The Compact has been under negotiations for fourteen years, but within Ways and Means jurisdiction for only seven days. Originally, H.J. Res. 187 was referred to this Committee for only four days. After the Committee acted, an extension of three days was granted so that an adequate report of the Committee's actions could be filed. The time allocatted was woefully inadequate to afford all members time to throughly analyze the Compact's ramifications.

I am satisfied, however, that despite the stringent timetable, the Committee has wisely rectified the serious trade and tax problems of the Compact as proposed. As proposed, the Compact would provide the Free Associated States unprecedented preferential trade treatment for a foreign country, create a haven from U.S. taxes, and lock in incentives for investment that the President's tax reform plan proposes to abolish or modify. The Committee has amended the Compact to provide trade treatment more in accord with the Free Associated States' status as a foreign country, prevent the Free Associated States from becoming a haven from U.S. taxes, and require that the Free Associated States have no special exemption from changes in tax law the Congress chooses to enact.

I commend the Chairman of the Committee for his leadership in correcting the shortcomings of the Compact as proposed, despite the short time allotted for Ways and Means consideration.

BRIAN DONNELLY.

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